Recent Developments in Sustainability Reporting

The ECCLblog

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Posted on October 26, 2014 by Remus Valsan

A new Directive on sustainability reporting

On 29 September 2014 the EU Council adopted a new Directive concerning disclosure of non-financial and diversity information by large companies and groups. The Directive proposal was drafted by the European Commission in April last year, and adopted by the European Parliament this April. The new Directive amends the recently adopted Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, which replaced the so-called "Accounting Directives" (the Fourth Company Law Directive 78/660/EEC on the annual accounts of certain types of companies and the Seventh Company Law Directive 83/349/EEC on consolidated accounts). The new Directive will enter into force 20 days after its publication in the EU Official Journal, giving the Member States two years thereafter to transpose it into national legislation.

The new Directive imposes on large companies a "report or explain" obligation. The reporting obligation applies to "public-interest entities" (as defined by Art. 2(1) of Directive 2013/34/EU) having more than 500 employees, i.e. approximately 6000 large companies and groups across the EU. Companies concerned are required to disclose in their non-financial reports information concerning their existing policies on environmental, social, employee, human rights, anti-corruption and bribery matters, including a description of the outcomes of their policies, relevant non-financial key performance indicators and main risks related to these matters. Companies which do not pursue policies for these matters will have to provide a clear and reasoned explanation for their choice.

In the UK, the majority of the disclosure requirements of the new Directive are already covered by the duty to prepare a Strategic Report. Sections 414 A-E of the Companies Act 2006, introduced by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, impose on companies other than those subject to the small companies regime an obligation to prepare a Strategic Report. The Strategic Report must include, among other matters, a description of the principal risks and uncertainties facing the company and an analysis, using key performance indicators, of relevant environmental and employee matters. Additionally, quoted companies must include in their Strategic Report information about the company's policies on environmental, employee, social, community and human rights matters as well as their policy on board diversity. The main change for UK companies introduced by the new Directive is the obligation to disclose the existing policies and outcomes on anti-corruption and bribery issues.

The Directive aims to strike a balance between constraining companies to be more transparent and ensuring an adequate degree of freedom on what and how to report. Companies will retain significant control on the extent of the information disclosed and the form in which it is made public. On the latter point, companies are free to choose the set of national or international non-financial disclosure guidelines that best suit their business.

Despite the recent proliferation of international reporting guidelines and standards, currently there is no generally accepted comprehensive international standard for disclosure of non-financial information. The sustainability reporting guidelines developed by the Global Reporting Initiative appear to be the most widely adopted non-financial reporting framework.[1] Currently in its fourth update (G4), the GRI framework provides guidelines on reporting formats, areas of disclosure and key performance indicators for all organisations, large and small, across the world.[2]

The global context

The adoption of the new Directive is part of a global trend to move away from a purely voluntary disclosure of non-financial information towards a stronger emphasis on mandatory disclosure. A recent joint study by UNEP, KPMG and GRI showed that approximately two thirds of the existing national reporting standards are mandatory.[3] At the same time, the joint study revealed an emerging trend to view mandatory and voluntary disclosure as complementary, rather than exclusive options. Many reporting entities go beyond the prescribed minimum and provide additional sustainability reporting as dictated by their business environment. A recent study prepared for the European Commission, for instance, shows that almost 80% of the world's 250 largest companies report on their sustainability.[4]

Given the current diverse international framework for sustainability reporting, as well as companies' increased appetite for voluntary disclosure, what is the actual utility of the new "report or explain" obligation introduced by the recent Directive? The Impact Assessment study accompanying the new Directive identifies two main problems that the instrument aims to address. The first one is a market failure evidenced by the fact that "companies have not been able to provide an appropriate response to users' and societal demand for non-financial transparency."[5] The second problem is a regulatory failure: legislation at both EU and Member-State level is unclear or inconsistent in terms of the disclosure requirements imposed, creating a multitude of reporting practices and formats that make comparisons across the Internal Market very difficult.

The alleged market failure raises a related question: who are the main intended recipients of the non-financial information disclosed? In the UK this question is unambiguously answered by the Financial Reporting Council's Guidance on the Strategic Report.[6] The strategic report should only contain information that is material to shareholders.[7] Its main purpose is to provide information to shareholders, to allow them to assess how the directors have performed their duty to promote the success of the company and to evaluate the past results and future prospects of the company.[8] At international level, a study carried by ACCA in 2010 across nine jurisdictions, covering both established and developing capital markets, unveiled that almost 90% of the surveyed preparers of sustainability reports considered shareholders and potential investors as the most important audience for their narrative reports.[9]

But are shareholders really interested in non-financial information? A particular class of investors certainly are: the socially responsible (or green or ethical) investors. The SRI movement has grown exponentially over the past decade in both the EU[10] and the US[11]. Do regular, profit-driven investors pay attention to non-financial information too? A 2008 study commissioned by ACCA and carried by David Campbell of Newcastle University and Richard Slack of Northumbria University[12] found that non-financial information is quite irrelevant for investment decisions of non-SRI institutional investors.

The Report canvasses the views that sell-side analysts in the banking sector hold on the utility of voluntary non-financial statements. The sell-side analysts are a vital link in the investment information supply chain. Their primary role is to interpret company reports and provide investment advice for buy-side clients and fund managers. They have significant influence on the ultimate decision of fund allocation. In fact, many investment houses impose on fund managers restrictions on investments that go against the explicit advice of the sell-side.[13]

The Report found that there is a general belief among sell-side analysis that narrative reporting was not immediately relevant in preparing forecasts and reports to the buy-side. Social and environmental reporting, in particular, was rarely read by analysts and "universally considered irrelevant and incapable of influencing a financial forecast".[14] The reasons for the total insignificance of sustainability reporting include lack of numerical content, too general or too complex information, and an assumption that the clients are not interested in non-financial information.[15]

How do these findings relate to the idea of a failure in the market for non-financial information? One possible interpretation is that there is no actual breakdown in supply and demand that would require legislative intervention: the main addressees of this information, for the most part, do not value it. A positive externality, however, is created for other stakeholders, such as NGOs and other civil society organisations. Another explanation of the Report's findings is the well-known problem of investor short-termism. Matters such as risk management policies or sustainability reporting are simply immaterial for short-term investors, although they are quire relevant for the company's long-term financial performance. A recent extensive study carried by Robert G. Eccles, Ioannis Ioannou, and George Serafeim showed that, in the long term, high sustainability firms (i.e. firms having long-standing sustainability policies and active processes of stakeholder engagement) outperform low sustainability ones in terms of both stock market and accounting measures.[16]

Yet another way of interpreting the Report is that it points to the poor quality of the non-financial information being provided: narrative reporting on sustainability matters is not factored into investment decisions because the information supplied is unreliable (not subject to independent verification) or insufficiently material, timely or comparable. [17] This leads to the second problem identified in the Impact Assessment for the new Directive: the regulatory failure, consisting in the fragmentation of the existing legal frameworks and inadequate cohesion and comparability of reporting practices.

How effective is the new Directive?

Does the new Directive go far enough in its prescriptions in order to correct the assumed regulatory failure? The instrument's preamble gives the concerned companies ample scope to choose the reporting framework it wishes from among the existing national and international guidelines: "undertakings subject to this Directive may rely on national frameworks, Union based frameworks such as the Eco-Management and Audit Scheme (EMAS), and international frameworks such as the United Nations (UN) Global Compact, the Guiding Principles on Business and Human Rights implementing the UN 'Protect, Respect and Remedy' Framework, the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, the International Organisation for Standardisation's ISO 26000, the International Labour Organisation's Tripartite Declaration of principles concerning multinational enterprises and social policy, the Global Reporting Initiative, or other recognised international frameworks."[18]

This non-prescriptive approach to reporting frameworks is justified by a concern for flexibility, but it is difficult to see how it will solve the regulatory failure problem. The Commission could have perhaps prescribed, or recommended, one of the existing reporting frameworks, such as the G4 by GRI. There are many precedents at national level in this respect. EU Member States, such as Austria, Belgium, Denmark, Finland, Germany, the Netherlands or Sweden, and countries outside the EU, such as United States and Canada, have a formal reference to GRI in their governmental corporate responsibility guidance documents or policies.[19] In Sweden, for example, state-owned companies must present a sustainability report in accordance with the GRI guidelines.[20]

Another option could have been to publish custom-made sustainability reporting guidelines at the same time as the Directive. The Commission undertook to prepare guidelines on methodology for reporting non-financial information, including non-financial key performance indicators. These guidelines, however, will be published within two years after the entry into force of the Directive and will be non-binding.[21]

What is next?

The current developments in reporting show that there is a global trend towards more extensive and more meaningful narrative reporting. The improvements in the quality and scope of reporting are driven by both regulatory demands and market demands for transparency. The future of narrative reporting seems to be the consolidation of both financial and non-financial information in a single integrated report. The recently established International Integrated Reporting Council (IIRC), a global coalition of regulators, investors, standard setters, accountants and NGOs, is working towards a global framework for integrated reporting that would bring together financial, environmental, social and governance information in one report.[22] It is hoped that the integrated reporting practice will lead to sustained integrated decision-making and actions that consider the creation of value over the short, medium and long term.

[1] The European Commission, "Impact Assessment Accompanying the Document Proposal for a Directive of the European Parliament and of the Council Amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups" (2013) available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013SC0127 ("impact Assessment") p 21.

[2] https://www.globalreporting.org/reporting/g4/Pages/default.aspx

[3] UNEP, KPMG, GRI and UCGA, "Carrots and Sticks: Promoting Transparency and Sustainability: An update on Trends in Voluntary and Mandatory Approaches to Sustainability Reporting" (2010), available at http://www.unep.fr/shared/publications/pdf/WEBx0161xPA-Carrots%20&%20Sticks%20II.pdf ("Carroets and Sticks") p. 13

[4] Katelijne van Wensen, *et al.*, "The State of Play in Sustainability Reporting in the European Union" (2011) available at ec.europa.eu/social/BlobServlet?docId=6728&langId=en

[5] Impact Assessment, p. 11

[6] https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf

[7] The FRC Guidance, para 5.1

[8] The FRC Guidance, paras 4.1 and 4.4

[9] ACCA and Deloitte, "Hitting the Right Notes, But What's the Tune?" (2010), available at http://www.accaglobal.com/content/dam/acca/global/PDF-technical/narrative-reporting/hitting_the_notes.pdf

[10] http://www.eurosif.org/our-work/research/sri/european-sri-study-2014/

[11] http://www.ussif.org/files/Publications/2013AnnualReport.pdf

[12] David Campbell and Richard Slack, "Narrative Reporting: Analysts' Perceptions of its Value and Relevance" (2008) ("Campbell and Slack") available at http://www.accaglobal.com/content/dam/acca/global/PDF-technical/narrative-reporting/rr-104-001.pdf.

[13] Campbell and Slack, p. 6

[14] Campbell and Slack, p. 5

[15] Campbell and Slack, p. 27

[16] Robert G. Eccles, Ioannis Ioannou, George Serafeim "The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance",.in Luigi Zingales and James Poterba, *Causes and Consequences of Corporate Culture* (forthcoming 2014), available online at http://www.nber.org/papers/w17950.

[17] See e.g. UNCTAD, "Investment and Enterprise Responsibility Review: Analysis of investor and enterprise policies on corporate social responsibility" (2010), available at http://www.unctad.org/en/docs/diaeed20101_en.pdf.

[18] Paragraph 9 of the Preamble.

[19] "Carrots and Sticks", p. 4

[20] "Carrots and Sticks", p. 66.

[21] Article 2 of the new Directive.

[22] http://www.theiirc.org/

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